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Brexit: A Pragmatic Trade Agreement?

Time Is Tight But Deal Remains Possible

Bettina Rudloff and Evita Schmieg

The negotiating mandates for the next round of Brexit talks are on the table. The European Union is making talks on a deal regulating EU/UK trade from 1 January 2021 conditional on reaching a fisheries agreement first – originally by July, although the precise timetable may be derailed by the corona crisis. The negotiating mandates diverge in significant respects: The European Union wants to safeguard its Single Market with its strong, shared regulation. That is also reflected in its recently published draft proposal for a trade deal. The United Kingdom seeks liberation from EU trade rules. These differences are substantial, and significant compromises will be needed if the talks are to be brought to a successful conclusion. Intelligent prioritisation and structuring could allow resolution of certain details to be postponed until a later date.

External trade and the internal market are communitised policy areas in the European Union. This makes them central issues for the British, as they seek to “reclaim their sovereignty”. Here – to a much greater extent than in areas such as foreign and security policy – Brexit has enormous ramifications for legislation and implementation. These are tough and time-consuming matters to negotiate. The further the United Kingdom seeks to diverge from the status quo, the harder it will be to complete the talks within the year.

The joint Political Declaration of October 2019 sketches the outlines of the future relationship between the European Union and the United Kingdom: Both sides envisage a comprehensive free trade agreement (FTA) and broad cooperation in various

sectors. In principle this should also include regulatory matters and cover services as well as goods. However, now that the negotiating mandates (and the EU’s initial offer) are on the table, it is apparent that significant differences remain to be bridged.

Different Starting Points

Both sides published their negotiating mandates at the end of February. According to the British document, London wants an agreement “on the lines of the FTAs already agreed ... with Canada and with other friendly countries”, with an Australian-style relationship as its fall-back. Given that the EU trades with Australia on WTO terms, the latter is a euphemism for a hard Brexit



without a trade agreement. In many areas the British mandate orientates on the EU's existing bilateral trade arrangements.

The EU's mandate lays out its objectives and outlines the issues it believes need to be addressed. As well as many familiar demands, the draft proposal for a trade deal contains a number of new elements.

The EU is seeking the closest possible trade partnership with the UK. But it also has fundamental principles it wants to see safeguarded. Brussels is willing to grant tariff- and quota-free access only in return for acceptance of all four freedoms of the Single Market. It should be noted that the kind of completely free access the UK imagines is something EU does not even offer to its closest partners in the European Economic Area (EEA), but only to developing countries (see Table on page 4).

The EU's strict approach to risk and regulation is also central. The precautionary principle is internationally contested, but entrenched and valued in European societies. The EU seeks to anchor it in new trade agreements, as occurred to a limited extent in the Comprehensive Economic and Trade Agreement (CETA) with Canada. It is unclear whether London also wishes to retain this principle; explicitly named in the mandate it is not.

The EU emphasises the "level playing field" in its talks with the UK, the idea being to guarantee fair terms of competition. The term and objective are a novum in trade talks, and underline the special nature of the UK's economic relationship with the EU. The "playing field" includes subsidies and tax policy as well as product standards.

Diverging overall priorities aside, particular sectors and issues will be especially problematic. The Table on page 4 shows examples of solutions already applied by the EU.

Agreement on Fisheries as Condition for Further Talks

The EU is making completion of a fisheries agreement by July 2020 a precondition for further talks on a trade agreement. The issues at stake are the future distribution of fishing rights and access to British waters for EU-based fishing vessels.

In course of the 1980s the Common Fisheries Policy (CFP) transformed national access and fishing rights. Rights to fish are governed by an EU-wide licencing regime, under which fish stocks are treated as a common European resource. Total permissible long-term catches are defined on the basis of scientific research and concretised as annual quotas. These are shared among EU member states under the principle of "relative stability", which guarantees fairness even where total catches have to be reduced — for example for the sake of sustainability.

The EU wants to keep this system, on account of the political sensitivity of the issue and widely diverging interests between member states. The UK has now put a new idea on the table: catches should be shared on the basis of where the fish stocks live ("zonal attachment"). This would grant the UK larger catches, but create a risk of overfishing. The UK also wants to reclaim control over access to its waters. That contradicts the EU's principle of "equal access". The EU's desire for stable long-term planning also clashes with London's wish for annual decisions on access and quotas. Access rights and quotas are closely intertwined. For example even if access rights are granted to a large number of vessels, low national quotas can still limit the total catch; this kind of issue therefore needs to be clarified jointly and strategically.

Brexit affects access and fishing rights in three geographical contexts, all of which need to be negotiated from scratch: (1) European access to British waters, in which more non-British than British vessels currently operate (including the distribution of quotas); (2) British access to European waters (and quotas), which today account

for 13 percent of the total British catch (110,000 tonnes annually); (3) British fishing fleets' access to international waters and fish stocks, which is currently governed by the EU's participation in regional fisheries agreements (for example for tuna), under which the UK receives a share. The disagreement is thus not only — as much of the British reporting would have it — about protecting British fish stocks from European rivals, but also about European and international fisheries in which the UK has an interest.

Border Controls Are Inevitable

The United Kingdom wants to quit the EU's Single Market and Customs Union. That means border controls for goods and rules of origin to prevent the misuse of preference schemes. This in turn incurs not insignificant costs for state administration and the private sector. Customs posts will have to be rebuilt and maintained indefinitely. According to the British National Institute of Economic and Social Research (2018), the resulting costs and smaller trade flows will leave British per capita GDP 3 percent lower than before Brexit (£1,000/year). Even if the UK remained in the Customs Union, the reduction in per capita GDP would still be 2 percent. It is currently conceivable that the impact of the corona crisis may overshadow the repercussions of Brexit, and that the "Brexit effect" will never become properly apparent. The confluence of the two developments certainly creates great problems for the UK.

Northern Ireland Protocol Creates Additional Difficulties

While Great Britain (GB) will cease to be part of the EU's Single Market on 1 January 2021, Northern Ireland will remain within it. All checks on goods will be conducted at the points of entry between Great Britain and Northern Ireland.

This arrangement for Ireland and Northern Ireland is defined in a protocol to the

Withdrawal Agreement. It was introduced in order to protect the 1998 peace settlement (the Good Friday Agreement), which is predicated on abolition of the physical border. That situation is to be preserved. The new customs border between the European Union and the United Kingdom will therefore run between Northern Ireland and the British mainland, not between Ireland and Northern Ireland — the latter being the national (political) border. This applies whatever trade agreement is concluded. Northern Ireland's regional parliament will have the right to review the arrangement every four years.

At the same time Northern Ireland will form a single customs area with the rest of the United Kingdom and as such participate in future British trade policy. British tariffs can be applied to goods from third countries, as long as there is no risk of them entering the EU through Northern Ireland. The British authorities will apply EU tariffs to goods destined for the EU. In other words, from 2021 Northern Ireland will belong to two trade regimes simultaneously. Dual membership of trade regimes — complete with different tariffs and standards — is a known phenomenon in Africa. Such a situation is practicable where controls at the borders ensure that the rules of the relevant end market are observed. The problem in this case is that *there must be no new border* between Northern Ireland and Ireland.

That creates a conundrum for any trade agreement between Brussels and London, because it will be difficult to verify and control goods entering the European Union from Northern Ireland. It is currently unclear how this can be resolved. Exports from the British mainland to *Northern Ireland* will not need to be controlled or restricted when they pass through the entry points. Once they reach Northern Ireland the goods will — under the terms of the Withdrawal Agreement — (as today) already be within the European Single Market, within which the EU undertakes no border controls. The UK on the other hand has the ability to control all goods crossing from Northern Ireland

EU models for tariff-free access and regulatory coordination

Field	Examples of models used in practice	
Free trade	Tariff- and quota-free market access	<ul style="list-style-type: none"> ■ Least Developed Countries (LDCs): Everything But Arms (EBA) ■ African, Caribbean and Pacific (ACP) states: Economic Partnership Agreements (EPAs)
	Deep coverage: goods, services, capital	<ul style="list-style-type: none"> ■ Canada: Comprehensive Economic and Trade Agreement (CETA)
	Tariff-free market access, but certain sectors excluded	<ul style="list-style-type: none"> ■ European Economic Area (EEA) (Iceland, Liechtenstein, Norway): agriculture and fisheries excluded ■ Euro-Mediterranean association agreements (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Tunisia)
	Sectoral tariff reduction agreements	<ul style="list-style-type: none"> ■ Switzerland: bilateral agreements, with linkage clause ■ United States: limited agreement planned
Regulation	WTO and WTO plus	<ul style="list-style-type: none"> ■ WTO: harmonisation of sanitary and phytosanitary standards (SPS standards) ■ WTO+: sustainability chapter in newer free trade agreements (FTAs)
	Voluntary cooperation	<ul style="list-style-type: none"> ■ Canada: chapter on regulatory cooperation (in CETA) ■ WTO cooperation guidelines
	Adoption of all EU regulations	<ul style="list-style-type: none"> ■ EEA with exception of agriculture and fisheries ■ Switzerland in scope of mutual recognition ■ Partnership countries: Euro-Mediterranean association agreements, association agreements with Eastern Partnership countries: (flexible) <i>acquis communautaire</i>
	Unilateral equivalence	<ul style="list-style-type: none"> ■ New Zealand: veterinary agreement ■ Argentina, Australia, Canada, Chile, Costa Rica, India, Israel, Japan, New Zealand, South Korea, Switzerland, Tunisia, United States: equivalence agreements for organic products ■ 15 agreements for financial services
	Mutual recognition	<ul style="list-style-type: none"> ■ Canada: mutual recognition in specific sectors, for example medical products (in CETA) ■ Japan: mutual recognition in specific sectors, for example motor vehicles ■ Switzerland: mutual recognition of conformity assessments
Fisheries	Access and fishing rights	<ul style="list-style-type: none"> ■ Within EU free access with principle of “relative stability” for quotas ■ 20 agreements with African and Pacific states: access and quotas negotiated ■ EU membership of 17 regional fisheries management organisations: access and quotas negotiated ■ Faroe Islands, Greenland, Iceland, Norway: bilateral agreements on reciprocal access, with annual adjustment

to the British mainland. In other words the concerns about subversion of standards and rules of origin are the EU's alone. In practical terms, the GB/NI checks might be based on whether the imported quantities correspond roughly to what the Northern Ireland market consumes. That is not a robust arrangement. The EU's negotiating mandate mentions the idea of mutual recognition of Authorised Economic Operators as another option, but that is far from being actionable.

Limits on the UK's Regulatory Independence

The global importance of non-tariff measures has grown considerably, with their impact today estimated to represent 1.6 percent of global GDP. Between OECD states tariffs themselves are currently less than 3 percent. Trade agreements today therefore focus on harmonisation or mutual recognition of standards and regulations. But this is harder to negotiate than tariffs on goods: non-tariff measures comprise a wide range of different instruments from procedural requirements through labelling rules to thresholds (for example for pesticides). They are politically sensitive, touching as they do on social and public preferences and on the different administrative traditions and systems of the countries involved.

Even if the UK does not accept any new EU standards from 2021 it will only be reclaiming a small sliver of its regulatory sovereignty. This is because WTO rules define in great detail a multitude of health-related standards such as pesticide residues in food or hygiene requirements in processing. Other standards are generally based on international compliance and certification rules. So there will be little national leeway there either. This applies in particular to standards that cannot be controlled directly in the product itself when it crosses the border (see SWP Comment 49/2014). Bilateral agreements can also affect the treatment of product standards in individual sectors (see Table on page 4). Examples of mutual recog-

nition of certification systems include the agreement between the EU and Japan (for motor vehicles) and CETA (for medical products). The EU also unilaterally recognises the certification processes of various third states for organic products.

It is by nature difficult to define how *future* changes in standards will be handled. Although the chapter on regulatory cooperation in CETA has a similar thrust (as did the abortive talks on a Transatlantic Trade and Investment Partnership, TTIP), both refer only to information exchange and coordination. Brussels is of course well aware of London's concern to assert sovereignty over regulatory matters, having itself experienced such concerns in association with the aforementioned negotiations. Because the European Union wishes to keep a closer trade relationship with the United Kingdom than it has with North America, it is seeking mechanisms to allay those fears when dealing with future divergence in standards (the level playing field).

Aside from the political question of harmonisation or recognition of standards between Brussels and London, powerful market mechanisms are also at play. The standards applied in the EU's very large market — with more than 500 million consumers — are strict in international comparison. Suppliers seeking to serve the EU market frequently orientate their entire production on those standards, it not being worthwhile to maintain separate product lines for smaller markets with different or lower standards. The EU's *de facto* dominance of international standards may be watered down in future as Asia — and in the longer term Africa too — continue to gain in importance. But in the medium term the UK will have to orientate on EU standards.

The Role of Trade Negotiations with Third Countries

London wishes to conclude its own free trade agreements, independently of the European Union. Here a distinction must

be drawn between two cases: Firstly, the UK is a party to forty-two EU FTAs, for which it needs to negotiate successor agreements. In about half of these cases — mostly with smaller partners — this has already occurred. These successor agreements are relatively easy to negotiate, because the central provisions can be taken from the EU's FTAs. But the UK is highly unlikely to achieve better market access than the EU enjoys, because many of EU's existing agreements (for example with Canada, Japan, Vietnam) contain so-called most-favoured-nation clauses. These require the respective partner to offer the EU the same trade terms for goods and services that it grants to other industrialised countries (in future including the UK). This could prove especially problematic for the British financial sector, where the UK hopes for greater openness and benefits from agreements with third countries. In 2018 the UK's trade in goods and services was estimated at £1.4 trillion, 11 percent of which was accounted for by countries with which the EU has trade agreements.

The instrument of agricultural tariff quotas used in many EU agreements creates problems for the UK with partners in the WTO and for future bilateral trade agreements. Tariff quotas restrict tariff reductions and/or exemptions to defined quantities of the respective product. Brexit sees the UK's large market for agricultural products, which has to date accounted for a significant proportion of imports under these quotas, removed from the EU. Now it must be decided how they are to be divided. The EU and UK have presented their WTO partners with a joint proposal for adjusting the total of 142 quotas covering 400 tariff lines with a trade value of €28 billion (2018): Under it the historic British share would be defined as a separate UK quota and subtracted from the EU quota. But many states, including Australia, New Zealand and the United States, object that separating the UK from the EU market reduces overall sales and increases their producers' costs for parallel import licences. They insist on larger British quotas, which British farmers reject

on the grounds that this would expose them to greater competition. *The EU's bilateral quotas* will remain unchanged in existing agreements, making them relatively larger for the now smaller EU market and increasing pressure on farmers. The UK should renegotiate on a case-by-case basis.

Secondly, the United Kingdom will be able to conclude completely new agreements after Brexit, for example with India or the United States. Indeed, 40 percent of British trade is with countries with which the EU has no FTA, including the United States as the United Kingdom's most important single trading partner. The UK has high hopes for these agreements, placing its faith in free trade and assuming that it will be able to make attractive offers to its partners. On the basis of good historical relations, London hopes for good access to Commonwealth countries and the United States. But the Commonwealth partners' dependency on and interest in the British market has shrunk in the wake of shifts in world trade and the growing importance of the emerging economies. Theresa May's initial talks with India in 2016 were not terribly promising. And it is highly unlikely that the United States under Donald Trump will be ready to make especially generous trade concessions to the UK. Ultimately, the UK will find itself facing the same problems as the EU did in prior negotiations on sensitive issues, for example if Washington demands access to the British market for genetically modified crops such as maize.

2020 Deadline Demands Pragmatic Approaches

Negotiating a trade agreement usually takes many years; CETA required seven. Unless a request to extend the transition period is lodged by 30 June 2020 — which the UK has excluded by law — the end of 2020 will be a cliff-edge for completing the trade talks. Even without the timetable being derailed by the corona crisis that is very tight — and even tighter for a fisheries agreement by July 2020.

Today the EU has forty-two trade agreements (including bilateral and regional economic partnership agreements), whose scope has grown steadily over time. The newer so-called deep and comprehensive agreements include regulatory topics that affect internal policies such as intellectual property protection or competition policy, as well as trade in goods and services. But the concrete shape of these can vary very widely. For example some exclude certain sectors, while others in contrast coordinate regulation only within particular spheres. These agreements contain modules on which the provisions of the future UK-EU FTA can be orientated (see Table on page 4).

Under a pragmatic approach the negotiating agenda can be stripped down and compromises achieved within the time available. Some of these are floated in the EU's draft proposal from March:

Alert and Governance Mechanism for Regulations. Detailed talks on rules and standards can be postponed until a later date and thereby left dormant until rules actually diverge in practice. Reliable notification of relevant changes would be essential, as proposed for a level playing field for state aid in the article on "New acts or provisions in the area of State aid control". A neutral instance would be established to determine whether such a case has occurred; it would also have to be able to sanction violations. The two sides would then either agree on a harmonisation, or decide to impose border controls and import rules for the products in question. In many cases this would permit agreement on standards to be pushed back into the implementation phase.

(Temporary) Focus on Specific Sectors. New import tariffs could remain limited to particularly sensitive sectors, as is the case with fish in the EEA. This would reduce the scope of the negotiations. Under a "negative approach" to regulation, one could start by excluding politically sensitive and symbolic sectors such as food from general coordination. This would publicly demonstrate London's regulatory sovereignty. On issues such as environmental and

social standards the EU's draft proposal insists on the rigid principle of "non-regression", in the sense of not falling below existing standards. One conceivable compromise would be mutual recognition of standards in particular areas — where agreement appears easier or where very dynamic developments mean that divergence is likely to occur sooner.

Tie market access for fish to fishing rights. Fishing rights are especially important for the UK, and highly symbolic despite the sector's small overall economic importance: It accounts for 0.1 percent of British GDP and employs 12,000 fishing crew and 14,000 processing workers, principally in Scotland. But it is also relevant in certain regions of the EU. For example, fish processing is a major employer in the German Baltic port of Saßnitz — and almost entirely dependent on German herring catches in British waters. The UK's abundant fish stocks represent a significant bargaining chip. The EU should exploit its dominance of the demand side of the equation, given that it takes 70 percent of all British fish exports. If agreement is not reached, a relatively high WTO tariff on fish of up to 26 percent can be imposed, which would potentially reduce sales. The EU should therefore make continued tariff-free access for British fish products conditional on the EU continuing to receive fishing rights in British waters. But it is questionable whether these rights would correspond to the status quo as the EU desires. The EU should also underline more clearly than to date that the UK could lose its access and fishing rights in European waters and would have to negotiate its own access to international waters. Such an arrangement would especially benefit Scotland, where a majority voted Remain but which is also home to most of the UK's pro-Brexit fishing communities which stand to benefit from more international catches and secure access to the EU's markets. British processors themselves emphasise the importance of preserving tariff-free market access.

The proposed negotiating deadline — assuming it survives the corona crisis — is

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extremely tight. But the starting situation is favourable compared to other negotiating processes. All earlier trade talks have been about reducing tariffs — on hundreds of lines — and harmonisation or mutual recognition of different sets of rules. In the case at hand, after forty-eight years of British membership of the EU and its predecessors, what London and Brussels need to decide is *whether* new tariffs are to be introduced and if they are, on which products, and to what extent hitherto uniform rules will be permitted to diverge. That means the need for negotiations is smaller than in other cases. Concretely: The further the new agreement diverges from the present situation of free market access with identical rules, the more complicated the negotiations will be and the longer they will take.

Almost half of British trade (49 percent) is with the EU. So the UK has a vital interest in open trade relations. In the other direction, the UK's share of the EU's external trade is only 13 percent. So the scales are skewed in the EU's favour. Nevertheless the European Union should show willingness to compromise: It also has its own interest in sustainable development and stability in its partner countries, especially those in the immediate neighbourhood. And it would be a good thing if it were possible for the UK to remain a valuable partner — and not only with an eye to future British generations potentially being more interested in closer relations with the EU.

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